Towards a New Paradigm for Development: Strategies, Policies, and Processes

Joseph E. Stiglitz
Senior Vice President and Chief Economist
World Bank

Given as the 1998 Prebisch Lecture at UNCTAD, Geneva
October 19, 1998

In an address to the World Institute for Development Economics Research (WIDER) in Helsinki at the beginning of this year,[1] I argued that we needed to go beyond the Washington consensus[2]: there were broader objectives to development than were embodied in that consensus, the set of policy recommendations upon which it focused was certainly not sufficient for development, and indeed some of the most successful developers had paid little heed to its dictums. That consensus all too often confused means with ends: it took privatization and trade liberalization as ends in themselves, rather than as means to more sustainable, equitable, and democratic growth. I talked there about many of the ways in which the Washington consensus had gone astray. It focused too much on price stability, rather than growth and the stability of output. It failed to recognize that strengthening financial institutions is every bit as important to economic stability as controlling budget deficits and increasing the money supply. It focused on privatization, but paid too little attention to the institutional infrastructure that is required to make markets work, and especially to the importance of competition.

In today's lecture, I want to go beyond these by now well-documented failures of the Washington consensus to begin providing the foundations of an alternative paradigm,

---

[1] Stiglitz (1998a).

[2] Throughout this speech, I have in mind a somewhat different conception of the Washington consensus than the one orginally outlined by my colleague John Williamson (1990), who coined the term. As Williamson (1997) himself notes, the term has evolved over time to signify a set of "neoliberal" policy *prescriptions*, rather than the more descriptive usage that he originally intended in discussing reforms undertaken by Latin American economies in the 1980s. The policies that now fall under the "Washington consensus" rubric are often—and, as I argued in my WIDER lecture, incorrectly—taken to be both necessary and sufficient for substantial development.

especially one relevant to the least developing country. It is based on a broad conception of development, with a concomitantly broader vision of development strategies and a quite different perspective on the role of international assistance and the ways in which it should be delivered. The remainder of this lecture is organized around five parts. First, I shall describe this broader vision. Second, I shall explain why not only the Washington consensus, but earlier development paradigms, failed: they viewed development too narrowly. I shall outline briefly some of the key factors—including recent events in East Asia and Russia—that have helped us realize the inadequacies of the old approaches. Third, I shall outline what I refer to as the key *principles* of a *development strategy* based on this broader vision of development. Fourth, I shall outline the major *components* of these new development strategies. And fifth, I shall conclude with some general observations, focusing on the importance of trade and the work of UNCTAD in furthering development based on this new paradigm.

I. Development as a Transformation of Society

Development represents a *transformation* of society, a movement from traditional relations, traditional ways of thinking, traditional ways of dealing with health and education, traditional methods of production, to more "modern" ways. For instance, a characteristic of traditional societies is the acceptance of the world as it is; the modern perspective recognizes change, it recognizes that we, as individuals and societies, can take actions that, for instance, reduce infant mortality, extend lifespans, and increase productivity. Key to these changes is the movement to "scientific" ways of thinking, identifying critical variables that affect outcomes, attempting to make inferences based on available data, recognizing what we know and what we do not know.

All societies are a blend. Even in more "advanced" societies there are sectors and regions that remain wedded to traditional modes of operation, and people wedded to traditional ways of thinking. But while in more advanced societies, these constitute a relatively small proportion, in less advanced societies, they may predominate. Indeed, one characteristic of many less developed countries is the failure of the more advanced sectors to penetrate deeply into society, resulting in what many have called "dual" economies in which more advanced production methods may co-exist with very primitive technologies.

Change is not an end in itself, but a means to other objectives. The changes that are associated with development provide individuals and societies more control over their own destiny. Development enriches the lives of individuals by widening their horizons and reducing their sense of isolation. It reduces the afflictions brought on by disease and poverty, not only increasing lifespans, but improving the vitality of life.

Given this definition of development, it is clear that a development strategy must be aimed at facilitating the transformation of society, in identifying the barriers to, as well as potential catalysts for, change. These notes outline some of the ingredients of such a New Development Strategy. Approaching development from the perspective of transforming society has profound implications not only for what governments and aid agencies do, but how they proceed -- how they engage, for instance, in participation and partnership. Thus, this paper can be seen as providing an analytic framework for much of the rethinking that has been occurring in the last few years about how best to promote development.

II. The Need for a New Development Strategy

The experience of the past fifty years has demonstrated that development is possible, but not inevitable. While a few countries have succeeded in rapid economic growth, narrowing the gap between themselves and the more advanced country, and bring millions of their citizens out of poverty, many more countries have actually seen that gap grow and poverty increase. Today the number of people living in poverty—even measured by the minimal standard of a dollar a day—is about 1.3 billion.[3] Strategies of the past, even when they have been assiduously followed, have not guaranteed success. Furthermore, many of the most successful countries (representing the largest part of growth within the low income countries) have not actually followed the "recommended" strategies, but have carved out paths of their own.

What Development Is Not: A Critique of Previous Conceptions

Many previous development strategies have focused on pieces of this transformation, but because they have failed to see the broader context, they have failed, and often miserably. Most of these have focused narrowly on *economics*. Economics is important: after all, one of the features which distinguishes more developed from less developed countries is their higher GDP per capita. But the focus on economics has confused not only means with ends, but also cause with effect. It has confused means with ends, because higher GDP is not an end in itself, but a means to improved living standards and a better society, with less poverty, better health, and improved education. Contrary to Kuznets's contention, by and large, increases in GDP per capita are accompanied by

[3] While the fraction of the world's population in absolute poverty -- living on under $1 a day -- has declined from an estimated 30.1 percent in 1987 to 29.4 percent in 1993, the total number of poor has increased, from 1.23 billion to 1.31 billion (World Bank 1996). The soaring population in some of the poorest countries makes the battle against poverty an uphill fight.

reductions in poverty.[4] It has confused cause with effect, because to some extent, the changes in society which may be called *modernization* are as much a cause of the increases in GDP as a result.

For more than four decades, development was seen (at least by those in the "mainstream") as mainly a matter of economics--increasing the capital stock (either through transfers from abroad or through higher savings rates at home) and improving the allocation of resources. These changes would lead to higher incomes and hopefully higher sustained growth rates.[5] Less developed countries were portrayed as identical to more developed countries--except perhaps in the extent of the inefficiencies in resource allocations (which, in turn, were related to the greater incidence of missing or malfunctioning markets). Economists of the left and the right differed in how best to improve resource allocation, and what role government should play. Economists of the left attributed the underlying problems to market failures. The thrust of the development programming models that were popular in the 1960s was for government, using these models, to replace the absent and imperfect markets, to guide the economy towards a more efficient allocation of resources. Economists of the right assumed, by contrast, that government was the problem: once government could step out of the way, markets by themselves would lead to efficient resource allocation. Thus, both saw the problem of development as one of improving resource allocation; they simply had different strategies for improving resource allocation. One sought to use government to complement markets, the other sought to reduce the role of government, which was seen as part of the *problem* of development, rather than as part of the solution. It was argued that governments claimed for themselves a role for which they were intrinsically unsuited. And overall, they claimed for themselves too large a role. Not only did they lack the capabilities to undertake

[4] For instance, Deininger and Squire (1996) find that 77 out of 88 decade-long periods of growth were accompanied by reductions in poverty. While from today's vantage point this may not seem surprising, it seems at odds with the conventional wisdom of the Kuznets curve. Kuznets argued that in the early stages of development, growth would be associated with increases in inequality; in fact, Deininger and Squire find that inequality fell as often as it rose during periods of growth. Kuznets, however, lacked the extensive cross-country datasets we have today, and his conclusion was based on data from only a handful of countries.

[5] Ironically, the growth theory literature that helped give rise to this conception of development emphasized that higher savings rates would lead to higher growth rates only *temporarily*.

a major role in resource allocation, but incentives in the political process ensured that whatever capabilities they had were often directed not at increasing national production, but at diverting rents to the politically powerful. The solution, in this perspective, was reliance on markets, and in particular, the elimination of government-imposed distortions associated with protectionism, government subsidies, and government ownership.

In the 1980s, the focus shifted to macroeconomic problems, to "adjustment" to fiscal imbalances and misguided monetary policies. Given the macroeconomic imbalances, it was impossible for markets to function, or at least function well.

Notice that all three of these development strategies saw development as a *technical* problem requiring technical solutions—better planning algorithms, better trade and pricing policies, better macroeconomic frameworks. They did not reach deep down into society, nor did they believe such a participatory approach was necessary. The laws of economics were universal: demand and supply curves and the fundamental theorems of welfare economies applied as well to Africa and Asia as they did to Europe and North America. These scientific laws were not bound by time or space.

The lessons of history

As remarkable as the narrow focus of these approaches was their lack of historic context. They failed to recognize that: (a) successful development efforts in the United States as well as many other countries had involved an active role for government; (b) many societies in the decades before active government involvement—or interference, as these doctrines would put it—failed to develop; indeed, development was the exception around the world, not the rule; and (c) worse still, capitalist economies before the era of greater government involvement were characterized not only by high levels of economic instability, but also by widespread social/economic problems; large groups, such as the aged and the unskilled, were often left out of any progress and were left destitute in the economic crashes that occurred with such regularity.

Indeed, one of the puzzles that these narrow approaches ignored was the failure of certain regions within seemingly developed countries to develop, such as the south of Italy. No trade barriers separated the north from the south; the overall macroeconomic framework in both regions was the same; and the south even benefitted from economic policies specifically designed to encourage it. Yet while the north boomed, the south stagnated. This by itself should have suggested that there was more to development than acknowledged by the technical approaches; for instance, trade liberalization, as valuable as it might be, would not solve the problem of Italy's south.

Defining Events

Three events of the past quarter-century have played a central role in helping to shape views concerning development strategies.

Collapse of the socialist/communist economies and the end of the Cold War

The first event is the collapse of the socialist/communist economies and the end of the Cold War. Some have focused on a single lesson that emerges—the inefficacy (and dangers) of a large government role in the economy. From this, some jump to the opposite conclusion: that reliance should be placed on markets.

But the failure of the Communist system was as much a failure of the political and social order on which it was based as of the economic system itself. The economic models that showed the equivalence between market socialism and capitalist economies were fundamentally misguided[6], partly because they did not grasp the role of institutions (beyond abstract markets) in the economy, but partly because they did not grasp the importance of the interface between the economy, narrowly defined, and society more generally.[7]

[6] See Stiglitz (1994).
[7] The inadequacy of the traditional perspectives is nowhere more apparent than in the experience over the past decade in the former Soviet Union (discussed below), particularly in contrast to the successful experiences in China, which managed to find strategies well adapted to its particular situation. One measure of China's success in devising a strategy: if the separate provinces of China were treated as separate "data" points, the 20 fastest-growing economies in the world between 1978 and 1995 would all have been Chinese (World Bank 1997a).

There are broader implications of the end of the cold war: The ideological debates should be over; there should be agreement that while markets are at the center of the economy, governments must play an important role. The issue is one of balance, and *where that balance is may depend on the country, the capacity of its government, the institutional development of its markets.* In other words, development advice should be adapted to the circumstances of the country.

The limitations of the Washington consensus

The second defining event was that many countries followed the dictums of liberalization, stabilization, and privatization, the central premises of the so-called Washington consensus, and still did not grow. The technical solutions -- the prescriptions of the Washington consensus -- were evidently not enough. This should not have come as a surprise; as I noted before, history was not encouraging. Moreover, developments in theoretical economics, many of which emphasized the limitations of the market, should have served to provide insights into both the historical as well as the more recent "market failures" of Russia and East Asia.

In many ways, the problems in Russia seem of a very different nature than those in East Asia, which I will discuss in greater detail in a moment: in Russia, we see an economy in transition facing huge government deficits and severe political problems. Yet there are some common threads. In both cases, the Washington consensus failed, and for similar reasons: a failure to understand the subtleties of the market economy, to understand that private property and "getting prices rights" (that is, liberalization) are not sufficient to make a market economy work. An economy needs an institutional infrastructure. To be fair, the "failures" in Russia were of an order of magnitude greater than East Asia, which had had remarkable growth, stability, and reductions in poverty over a span of more than a quarter century. While the banks in East Asia lacked adequate supervision, the banks in Russia not only lacked that supervision; they did not even perform their core function of providing capital to new and growing enterprises. We all know that the standard theorems of economics emphasize that an economy needs both private property and competition. The Washington consensus, while occasionally paying lip service to the latter, placed its emphasis on the former, thinking that with private property, at least owners would have an incentive to increase efficiency. Worries about distribution and competition—or even concerns about democratic processes being undermined by excessive concentration of wealth—could be addressed later! Russia succeeded in turning ordinary economic laws on their head, in that it managed to reverse the usual trade-offs between equity and efficiency. Reforms such as moving from inefficient central planning to decentralized pricing mechanism, from inefficient state ownership to private property and the profit motive, should have increased output, even if perhaps at the price of a slight increase in inequality. Instead, Russia achieved a huge increase in inequality, at the same time that it managed to shrink the economy, by up to a third according to some estimates. Living standards collapsed with GDP statistics, as life spans were shortened and health worsened. All too late, it was recognized that without the right institutional infrastructure, the profit motive—combined with full capital market liberalization—could fail to provide incentives for wealth creation and could instead spark a drive to strip assets and ship wealth abroad.

The East Asian miracle

The third defining event was the East Asian miracle: the rapid growth of the countries of East Asia showed that development was possible, and that successful development could be accompanied by a reduction of poverty, widespread improvements in living standards, and even a process of democratization. But for those advocating the technical solutions, the East Asian miracle countries were deeply disturbing. For these countries did not follow the standard prescriptions. In most cases, government played a large role. They followed some of the standard technical prescriptions, such as (by and large) stable macroeconomic policies, but ignored others. For example, rather than privatizing, government actually started some highly productive steel mills, and more generally pursued industrial policies to promote particular sectors. Governments intervened in trade, though more to promote exports than to inhibit particular imports. And governments regulated financial markets, engaging in mild financial restraint, lowering interest rates and increasing profitability of banks and firms (as opposed to financial repression, which results in negative real interest rates.) Many of the policies on which the governments focused were simply areas that had been ignored in the past; these included, for example, the heavy emphasis on education and technology, on closing the knowledge gap between them and the more advanced countries.[8] While the impact of individual policies remains a subject of dispute, the mix of policies clearly worked well. Perhaps had these countries followed all of the dictums of liberalization and privatization, they would have grown even faster, but there is little evidence for that proposition. In some cases, such as financial restraint, there is some evidence—as well as a considerable body of theory—that suggests that these policies did enhance growth.

But perhaps the most important lesson of East Asia was that, to a large extent, they succeeded in a transformation of their societies, a fact that is evident to any visitor to the region. To be sure, the transformation is far from complete: witness the sectors in several of these countries that exhibit rigidities and have failed to adopt modern technologies and modes of business. And while the crisis facing East Asia today has raised questions in many circles concerning the East Asia miracle, the fact of the *transformation* remains. Even if these countries face a few years of zero or even negative growth, their per capita GDP as they enter the twenty-first century will be a multiple of what is was a half-century ago, and far higher than countries that have pursued alternative development strategies. Equally important, poverty rates will be a fraction of what they were a half-century ago, though undoubtedly higher than at the beginning of the decade. Literacy will remain near-universal, and health standards will remain high. A careful reading of the East Asian experience over the last several decades—of what strategies led to those remarkable achievements—will reveal that many of the views reflected here were incorporated in the development strategies of the fastest developers.[9]

[8] Though, to be sure, these had been important components of the U.S. development strategy in the nineteenth century.
[9] See World Bank (1993) and Stiglitz (1996).

The East Asia crisis

This is not the place for an extended exegesis either of the crisis' cause or its depth, and I have spoken extensively about these matters elsewhere.[10] Nevertheless, there are important lessons to be learned from the crisis concerning the design of development strategies. These lessons have not been completely lost on the world over the past year, even if they have at times become, in my view, somewhat muddled.

To show how views about development have begun to change because of the crisis, it is worth thinking back to 1997. How much the world has changed in but a short year! A little more than a year ago, in Hong Kong, there was a debate about extending the IMF charter to include a mandate for capital market liberalization. Critics of hedge funds were seen as financial Luddites who wished to reverse the course of history and the inevitable domination of free markets.

Today, there is widespread recognition that even countries that pursue good economic policies can suffer from the volatility of short-term capital flows. While the risks and market failures (including externalities associated with contagion and systemic failures[11]) associated with short term capital flows have now become apparent, the benefits, especially for countries like those in East Asia with high savings rates, remain unproven[12]. But the East Asia crisis has raised questions about the Washington consensus itself: the source of the problems were items that were simply not emphasized in the earlier policy prescriptions. Ironically, in identifying these new sources of potential problems, much of the popular discussion has shifted attention away from another set of problems--that associated with the financial and capital market liberalization which were a central part of the Washington consensus.

[10] See, for instance, Furman and Stiglitz (1998) and Stiglitz (1998b) and (1998c).

[11] The arguments for bailouts, as well as the presence of bailouts themselves, provide overwhelming support for the view that there may be marked discrepancies between private and social net return to short term capital movements. These discrepancies at the very least call for a review of feasible government actions to redress this market failure, which has imposed such huge costs on millions and millions of people (though to be sure, some of these costs might have been reduced if the crisis-response polices had been better designed).

[12] See Furman and Stiglitz (1998) for a discussion of both the evidence and the theory explaining why the result that liberalization does not yield higher growth (see, e.g. Rodrik 1998) should not come as that much of a surprise.

Thus, while the countries of East Asia that encountered economic problems were widely chastised for having weak financial institutions, the Washington consensus had failed to stress that weak financial institutions could be as important a source of macro-instability as excessive government deficits. And much of the recent discussions have failed to note the role that financial market liberalization--often under pressure from outsiders--played in contributing to the weaknesses in financial institutions.[13] It is far easier to strip away regulations than to create the requisite institutional infrastructure for financial markets to function. For a recent reminder of the difficulties of regulating financial institutions (including banks)—even in the most developed economies—we need only consider the bailout of Long-Term Capital Management, the huge US-based hedge fund that reportedly before its crash had an exposure of more than a trillion dollars.[14]

Indeed, it can be argued that excessively risky lending and inadequate financial-sector supervision in the developed countries contributed to the crisis. We now realize that for every borrower there is a lender, and the lender is as much to blame as the borrower. Thus, if the borrowers in East Asia are to blame, so too are the developed-country lenders. And to the extent that the foreign banks were *marginal* lenders, they deserve even more of the blame: foreign lenders to Korea's highly leveraged firms (or to banks that had themselves made extensive loans to highly leveraged firms) knew that these enterprises' debt-equity ratios were far higher than any financial analyst would have called prudent. Yet supposedly well-managed banks, supervised by supposedly sophisticated regulatory authorities, made these loans. Moreover, these loans were not driven by government

[13] Research by Demirgüç-Kunt and Detragiache (1998) in fact shows the systematic relationship between financial market liberalization and economic crises.

[14] The bailout has raised a lot of questions that put a new perspective on the charges in East Asia: Did the bailout represent crony capitalism, given that one of the partners in the hedge fund was a former vice-chairman of the Federal Reserve Board? Did the regulators really not realize the size of the threat? And if so, what does this say about the supervisory capacity of supposedly the most sophisticated regulators in the world, with the longest tradition of regulation, extending for almost a century and a half? If not, what does this say about their understanding of financial markets? Or was the defense of the government role—the threat of contagion—just a cover-up? While Federal funds were allegedly not involved, did the discretionary regulatory powers provide implicit threats (of tighter supervision in the case of non-cooperation) and promises (of regulatory forbearance if the bailout proved costly)? Was there a deliberate attempt by all participants to restrict transparency, by not revealing to the market all the relevant information?

pressure. Is there a suggestion that in some countries bad loans result only from crony capitalism, while in others, they result from the natural working of market processes?[15]

The East Asia crisis has not only put a sharper spotlight on financial institutions, but on broader aspects of political and economic life. For instance, lack of transparency has been widely identified as contributing to the crisis. There is little econometric evidence in support of that conclusion[16]—and our skepticism is reinforced when we remember that the previous three major crises occurred in Scandinavian countries, which are among the most transparent in the world. But the emphasis on transparency is welcome, in that it raises the importance of broader societal issues. Transparency is necessary for effective participation in decision-making, and participation, I shall argue, is an essential part of successful development as a transformation of society.

[15] For instance, there is no evidence that government pressures caused the excessive real-estate lending in Thailand.

[16] See, in particular, Furman and Stiglitz (1998). They show that transparency in East Asia on average (at least as gauged by standard measures) was no less than in other countries that did not experience a crisis; the crisis countries of East Asia had had three decades of remarkable growth, yet if anything transparency had increased rather than decreased prior to the crisis.

III. The Principles of the New Development Strategy

The new development strategy takes as its core objective *development, the transformation of society*. It recognizes that an integral part of successful development is the increase in GDP per capita. But this is only part of the story, and even this will not be achieved unless the country adopts a broader development focus. If successful, the new development strategy will not only raise GDP per capita, but also living standards, as evidenced by standards of health and literacy. It will reduce poverty—our goal should be its elimination, a goal that the more successful economies have actually attained (at least by the *absolute* poverty standard). It will be sustainable, strengthening the environment. And the real societal transformations will enhance the likelihood that the underlying policies will be durable, withstanding the vicissitudes sometimes accompanying democratic processes.

The discussion of *principles* is divided into three sections: what development strategies are, and how they differ from *plans*; how we can catalyze *society-wide* change; and why *participation and ownership* are crucial.

The Concept of Development Strategies

Corporations have increasingly found corporate strategies of use in guiding their thinking and longer-term investments. Development strategies need to be thought of in the same light, rather than as the detailed programming models and development plans of the past, which originally grew out of an attempt to make central planning work. Development strategies, while in some ways less detailed than these planning documents, are in many ways more ambitious, for they set out a strategy not just for the accumulation of capital and the deployment of resources, but for the transformation of society.

A development strategy needs to set forth the *vision* of the transformation, what the society will be like ten to twenty years from now. This vision may embrace certain quantitative goals, such as a reduction in poverty by half, or universal primary education, but these are elements in or targets for the transformation process, not the vision of the transformation itself.

This vision needs to include a view of the transformation of institutions, the creation of new social capital and new capacities, in some cases to replace traditional institutions that will inevitably be weakened in the process of development. In other cases, the new institutions will contain within them elements of the old; there will be a process of evolution and adaptation. Some of these transitions may be difficult, either to articulate or to implement: How will societies that have traditionally discriminated against women achieve a higher degree of equality, at the same time that they maintain traditional values?

A development strategy has sometimes been likened to a blueprint, a map of where the society is going. But this metaphor is misleading, and understanding why helps us to see the difference between plans of the past and development strategies of the future. The development process is too difficult for us to write down today a blueprint or a map of where the economy will be going over the next ten years, let alone a quarter of a century. Doing so requires too much information, knowledge that is not currently available. In the past, planning documents have failed to take into account virtually any of the major uncertainties facing the development process. While in principle, a development plan could map out how the economy would respond to the myriad of different contingencies that might occur in the coming years, in practice this is seldom done.

By contrast, a development strategy is a living document: it needs to set forth how it is to be created, revised, and adopted, the process of participation, the means by which ownership and consensus is to be obtained, how the details will be fleshed out.

The development strategy fulfills several functions as it sets forth its vision for the future:

Development strategies and priorities. All societies are resource-constrained; poor countries even more so. Beyond general resource constraints are the constraints on the capacity of government, the limitations on the number of issues which it can pursue. While there are many pressing needs, it is imperative that the development strategy set priorities.

A key aspect of prioritization is an awareness of sequencing: what tasks have to be done before other tasks. It may, for instance, be essential to establish a competition and regulatory framework before privatization; or it may be essential to establish a financial regulatory framework before capital market or financial sector liberalization.

Development strategies and coordination. In traditional economic theory, prices perform all the coordination that is required in an economy. But this requires a full set of markets—an assumption that patently is not satisfied in less developed countries. Having a sense of where the economy is going is essential: if, for instance, an economy is to move to the "next" stage of development, the appropriate infrastructure, human capital, and institutions all have to be in place. If any of the essential ingredients is missing, the chances of success will be greatly reduced. Not only must there be coordination of different agencies within and among levels of government, there must be coordination between the private sector and the public, and among various parts of the private sector.

The kind of coordination provided by the development strategy is markedly different, both in spirit and detail, from the kind envisioned (but never actually achieved) in indicative planning. While indicative planning saw itself as a substitute for missing markets, attempting to provide detailed coordination of input and output decisions of various industries, development strategies focus more on the broader vision, including entry into new technologies or new industries.

Development strategies as consensus builders. The process of constructing a development strategy may itself serve a useful function, in helping build a consensus not only about a broad vision of the country's future, and key short- and medium-term objectives, but about some of the essential ingredients for achieving those goals. Consensus-building is not only an important part of achieving political and social stability (and avoiding the economic disruption that comes when claims on a society's resources exceed the amount available[17]), but it also leads to an "ownership" of policies and institutions, which in turn enhances the likelihood of their success.

Catalyzing Society-Wide Change: Beyond Enclaves and Projects

If the transformation of society is at the heart of development, the question becomes how to bring these changes about. One of the major roles of the development strategy is to serve as a catalyst, for example by identifying the areas of a country's (dynamic) comparative advantage. Identifying these areas and publicizing such information is a *public good*, and as such is a responsibility of government.

Transforming whole societies. To be effective, this attempt to serve as catalyst will need to embrace the ambitious goal of encouraging *society-wide* transformation. Earlier, we noted that all too often, development efforts succeeded in transferring technology without transforming societies, in the process creating dual societies with pockets of more advanced technology but little more. In a sense, duality—in which only isolated enclaves are developed—represents a failure of the development process. Our goal is to understand in part what went wrong, why these enclaves did not serve as "growth poles," catalysts of development beyond their narrow confines.

The same could be said about many development projects. A project may be "good" in the sense that it yields high project returns, but it may have little development impact. Of course, high returns are better than low, but if benefits do not spread to the broader society, then the project cannot be judged a true success.

In some cases, the lack of development impact may result from *fungibility*: a country has a range of projects that it wishes to undertake, some with high social returns and some with low, perhaps even negative, returns (sometimes because they are designed primarily to enrich the ruling elites). The country "sells" the good projects to the aid

[17] For an analysis of the effects of hyperinflation, often caused by such an imbalance between resources and objectives, see Bruno and Easterly (1998).

donors, which allows it to shift its own resources from those projects to others that have low social returns. Ascertaining the *additionality* associated with a project—what occurred that would not otherwise have happened—is often difficult if not impossible. But in any case, we should be aware that the marginal contribution may be far different than it appears at first blush.

Part of the government's role as a catalyst is undertake projects that can lead to *social learning*—that is, projects from which the country can draw widely applicable lessons, for instance about the viability of an industry. The benefit of the investment is not just the direct returns from the project, but also what can be learned for other projects from its success or failure. Because these learning benefits cannot be appropriated fully by private agents, there will be too little of this kind of experimentation within the private sector. A critical aspect, then, of the government's decision to undertake a particular project should be whether it can be *scaled up*. A project that succeeds only because of massive investment of resources that could not be mobilized more generally, or only due to an input that is not generally available, is not a good candidate for scaling up.

To make this point more concrete, let me suggest a couple of examples. A project that provides more textbooks to a school may, for instance, be able to increase the effectiveness of that school, but if there are no resources available to provide similar textbooks to all schools, the project will have very limited development impact. By contrast, a project that develops a new curriculum, one that is better suited to the conditions of the country and motivates children and their parents more effectively, can have nationwide impact. A project that demonstrates that local participation in education and local control of rural schools increases school accountability (as in El Salvador[18]) or student performance (as in Nicaragua[19]) could be replicated nationwide (or indeed, even worldwide), with limited additional resources. Indeed, such local involvement can itself be a catalyst for community-based development efforts that go beyond education. There are strong *externalities* associated with such projects. Not only do others learn *directly* from how the project itself performs, but in the process of learning to interact to address

[18] See Jimenez and Sawada (1998).
[19] See King and Ozler (1998).

educational problems, the community learns how to deal with other issues as well, how to engage each other in a process of consensus formation. This concern with scaling up must be at the core of government's involvement with projects, if that involvement is really to have the desired transformative effect.

Participation, Ownership, and the Role of Outsiders

Seeing development as a transformation of society also has clear implications for where the locus of development efforts must be, and how the process of assistance must be organized, as I will explain in this section.

Why imposing change from the outside cannot work

This much seems clear: effective change cannot be imposed from outside. Indeed, the attempt to impose change from the outside is as likely to engender resistance and give rise to barriers to change, as it is to facilitate change. At the heart of development is a change in ways of thinking, and individuals cannot be forced to change how they think. They can be forced to take certain actions. They can be even forced to utter certain words. But they cannot be forced to change their hearts or minds.

This point was brought home forcefully at a recent meeting of finance ministers and central bank governors from the countries of the former Soviet Union. All could articulate perfectly the requirements of sound macro-policy, as each announced that he subscribed to those policies 100 percent—including those whose practices deviated markedly from the professed beliefs.

Indeed, interactions between donors and recipients may sometimes actually impede the transformation. Rather than encouraging recipients to develop their analytic capacities, the process of imposing conditionalities undermines both the incentives to acquire those capacities and recipients' confidence in their ability to use them. Rather than involving large segments of society in a process of discussing change—thereby changing their ways of thinking—excessive conditionality reinforces traditional hierarchical relationships.

Rather than empowering those who could serve as catalysts for change within these society, it demonstrates their impotence. Rather than promoting the kind of open dialogue that is central to democracy, it argues at best that such dialogue is unnecessary, at worst that it is counterproductive.

Ownership and participation

Thus, key ingredients in a successful development strategy are *ownership* and *participation*. We have seen again and again that ownership is essential for successful transformation: policies that are imposed from outside may be grudgingly accepted on a superficial basis, but will rarely be implemented as intended. But to achieve the desired ownership and transformation, the process that leads to that strategy must be participatory. Development cannot be just a matter of negotiations between a donor and the government. Development must reach deeper. It must involve and support groups in civil society; these groups are part of the social capital that needs to be strengthened, and they give voice to often-excluded members of society, facilitating their participation and increasing ownership of the development process.[20] By involving these groups, the process of strategy formulation may be able to elicit the commitment and long-term involvement that is necessary for development to be sustainable. Ownership and participation are also necessary if the development strategy is to be adapted to the circumstances of the country; our research shows that projects with higher levels of participation are in fact more successful, probably in part because those projects make fewer erroneous assumptions about the needs and capabilities of beneficiaries.[21]

Outside agents, including donors, can encourage ownership through persuasion—that is, through presenting evidence, both theoretical and empirical, that particular strategies and policies are more likely to bring success than other approaches. But the degree of ownership is likely to be even greater when the strategies and policies are developed by those within the country itself, when the country itself is in the driver's seat.

[20] Whether or not these groups are representative needs to be borne in mind, of course, when we assess the weight that should be accorded this voice in the expression of development strategies.
[21] See World Bank (1998b), Isham, Narayan, and Pritchett (1995), and World Bank (1995).

Some, in their enthusiasm for ownership and participation, have implied that these participatory processes by themselves would suffice. But while individuals within a community may actively participate in discourse about what to do and how to do it, there must be more to this process than simple discourse. First, for participation to be fully meaningful, it should be based on knowledge; hence the crucial role of education and of capacity building. Second, merely calling for participation does not resolve the issue of *incentives:* individuals (and groups of individuals or organizations) need to be motivated to be involved. In particular, it will be difficult to sustain participation if participants sense that they are not being listened to, that their views are not taken into account in decision-making. There has to be a sense that the *process* of decision-making is a fair one, and this in turn requires participation in the process that constructs institutional arrangements for decision-making. Even if there has been full *representative* participation, each individual has to have appropriate incentives to take the desired actions. Indeed, one of the reasons for participation is so that policymakers can have a better understanding of what incentives are necessary. Institutions, incentives, participation, and ownership can be viewed as complementary; none on its own is sufficient.

Participation and ownership are crucial, then, and it is clear that the involvement of outsiders cannot take the place of this local ownership. Nevertheless, as I will discuss later, outsiders do have a role in facilitating the process, and in assisting in the provision of resources and knowledge.

The need for inclusion and consensus-building

One of the obstacles to successful development has been the limited ability of some countries to resolve conflicts. The ability to resolve disputes is an important part of social and organizational capital. Reforms often bring advantage to some groups while disadvantaging others. There is likely to be greater acceptance of reforms—and a greater participation in the transformation process—if there is a sense of equity, of fairness, about the development process, a sense of ownership derived from participation, and if there has been an effort at consensus formation. Numerous examples (such as Ghana) have showed the importance for instance of consensus formation in achieving macroeconomic stability.

By contrast, a decision to, say, eliminate food subsidies that is imposed from the outside, through an agreement between the ruling elite and an international agency, is not likely be helpful in achieving a consensus—and thus in promoting a successful transformation.

IV. The Components of a New Development Strategy

While the details of a development strategy will differ from country to country, one constant is that since a development strategy outlines an approach to the transformation of society, it must address *all components* of society.

Loci of development

In particular, a strategy must include components aimed at developing the private sector, the state (the public sector), the community, the family, and the individual. The different components of the development strategy are intricately interrelated. For instance, at the center of the strategy for the development of the individual is education; but enhancing skills is also critical for the private-sector strategy, and the increase in wages for women that results from improved female education has a strong bearing on the family.

(a) Private sector development. In the past, too often development strategies focused on government; this was natural, given that to a large extent, the "plan" was a plan for *public* action, a blueprint for the government. But given the broader role that we see for *development strategies*, it is natural to begin our discussion with the private sector, which will, after all, typically be at center stage.

A key objective is the creation of a strong, competitive, stable and efficient private sector. Among the elements of strategies which advance that objective are

- A legal infrastructure, providing (and enforcing) competition laws, bankruptcy laws, and more broadly commercial law
- A regulatory framework which encourages the private provision of infrastructure where possible, which maximizes the extent of feasible competition, and which ensures that where competition is not possible, there is not abuse of market power
- The government provision of infrastructure, where private infrastructure does not occur
- A stable macroeconomic framework

- A stable and effective financial system, which requires a regulatory framework that not only ensures safety and soundness, but also enhances competition, protects depositors, creates confidence that there is a "level playing field" in securities markets by protecting investors from abuses, and identifies underserved groups within society
- An adjustment strategy, a strategy for the elimination of those distortions in the economy that interfere with the efficient deployment of resources.

The failure to establish some of the key institutional predictions to a market economy is perhaps one of the factors contributing to the failures in the transition to a market economy of many of the countries of the former Soviet Union. The failure to establish a sound legal and regulatory environment for banks, securities markets, and the financial sector more broadly is now recognized to have played a large role in the East Asia crisis. Indeed, the importance of the financial sector for development had been reflected not only in the World Bank's research, but in the Strategic Compact that was formulated well before the East Asia crisis occurred.[22]

If the private sector is to flourish, the environment must be conducive to private-sector development. A key part of that environment is the quality of the labor force -- an educated, healthy workforce is essential.

(b) Public Sector Development. The development strategy needs to pay particular attention is the public sector. After all, if the government cannot manage its own affairs, how can it be expected to manage (or even affect in an appropriate way) the affairs of others? The key question behind the strategy for the public sector is to identify the role of the government—both what the government should do and how it should do it. And the question should not be whether a particular activity should be carried on in the public or private sector, but how the two can best complement each other, acting as partners in the development effort. Related issues include what tasks should be undertaken at what level

[22] For a description of the Strategic Compact, see http://www.worldbank.org/html/extpb/annrep97/overview.htm.

of government, and how governments can most effectively interact with "civil society," creating the conditions that are most conducive to the transformation of the whole society.

Central ingredients to the public sector strategy[23] are (i) a focus of the public sector on the unique functions that it must perform, such as: creating the enabling environment for the private sector, discussed in previous paragraphs; ensuring that health and education are widely available; and spearheading the drive to eliminate poverty; (ii) a strengthening of the capabilities of the public sector, including the development of an effective civil service, and a restructuring of the public sector, to make more effective use of incentives and of market and market-like mechanisms; and (iii) a matching both of responsibilities and modes of operation to the capabilities of the State.

(c) Community development. While certain activities are most effectively undertaken at the national (or international level), much of life centers around communities, and communities are often the most effective vehicle for bringing about the transformation of society. National governments are simply too remote, and the opportunities for meaningful participation are too limited. Well-designed development projects (such as those that have been financed through social funds) can be a catalyst for community development. Participation at the community level allows the project choice to reflect the needs and preferences within the community, and the project design to reflect the local information, ensuring that local conditions, preferences, and circumstances are taken into account. Equally important, local participation engenders commitment, which is necessary for project sustainability over the long run. And participation in the project itself becomes part of the transformation process. There is growing evidence concerning the relationship between participation and development effectiveness.

(d) Family development. A major determinant of success in raising income per capita is population growth, which stems from decisions made within the family. Another major determinant is female education, also a decision made within the family; the impact of female education is reflective of the key role that women play in educating the next

generation. During the key formative years of a child, the family is responsible not only for education, but for nutrition and health. More broadly, we have become increasingly aware of the importance of family development, of what goes on within the household. And just as we have become aware of the power of the family as an instrument for development, we have also become aware that in many parts of the world, there are frequent instances of dysfunctional behaviors, including within family violence.

(e) Individual development. In the end, the transformation of society entails a transformation of the way *individuals* think and behave. Development entails the empowerment of individuals, so that they have more control over the forces that affect their lives, so that they can have a richer, healthier life. Education and health are at the center of efforts at individual development.

Resources, knowledge, and institutions

We have provided a framework for thinking about development strategies that focuses on five levels—the private sector, the government, the community, the household, and the individual. A second cut at the development strategy approach emphasizes not the levels on which it operates, but what it must provide:

(a) Resources. As I noted earlier, development entails more than resources: returns to capital, even defined broadly to include human capital, depend heavily on the availability of complementary inputs such as a well-managed economic environment and well-functioning institutions. Nevertheless, it is clear that resources are an important ingredient in development. A development strategy must outline plans for developing physical capital and human capital, as well as preserving natural resources; plans for encouraging saving and investment, and for filling the gap between the two; plans for schools and for financing them; plans for using and renewing natural resources.

---

[23] See the 1997 World Development Report, *The State in a Changing World* (World Bank 1997b).

(b) Economic Management. One of the defining characteristics of less developed countries is a paucity of resources, which is why it is all the more important that the resources that are available are well deployed. Comprehensive development strategies must set out to identify the most important distortions in the economy, and how they are to be addressed, taking full account of the social costs and distributional impacts of policies. Accordingly, the ingredients in economic management need to be broader than the traditional lists, which focused largely on liberalization, privatization, and macro-stability.

(c) Knowledge management. Development requires closing the gap not only in "objects," in human and physical capital, but also in knowledge. Knowledge and capital are in fact complements: improved knowledge enhances the return to capital, while additional capital provides the opportunity to make use of recently acquired knowledge. Incorporating knowledge into the development strategy requires creating capacities to absorb and adapt knowledge (through investments in human capital and in research institutions), investing in technologies to facilitate the dissemination of knowledge, and creating knowledge locally. Thus, a development strategy needs to outline a strategy of knowledge management. The World Bank increasingly thinks along these lines, conceiving of itself as a *knowledge bank*, with one of its central tasks being to help countries to close the knowledge gap.[24] It can provide the cross-country experience that, when melded with local knowledge, makes possible effective choices of development policies, programs, and projects.

(d) Sector and sub-national strategies. In many cases, it is useful to narrow one's focus from the whole economy to a sector, to some industry (the health care sector, or agriculture), to some region, to cities (an urban strategy), or to the rural areas. The cities represent an arena in which a cluster of concerns jostle together forcefully—infrastructure, the environment, health, finances. In some ways, cities are microcosms of the economy as a while, and integrated solutions to a city's problems may provide insights into integrated solutions for the economy as a whole. Moreover, many cities have been more successful in

achieving modernization than rural areas, and it is thus natural to focus particularly on cities in trying to achieve societal transformation.

(e) Social and organizational capital. Another form of capital, beyond physical capital, human capital, and knowledge, is also essential for a successful transformation: social and organizational capital, which includes the institutions and relations that mediate transactions and resolve disputes. I will elaborate a bit on this point, because it is too often given short shrift in policy discussions. Traditional societies often have a high level of organizational and social capital, though this capital may not be of a form that facilitates change. But in the process of development, this organizational and social capital is often destroyed. The transformation may weaken traditional authority relationships, and new patterns of migration may sever community ties. The problem is that this process of destruction may occur before new organizational and social capital is created, leaving the society bereft of the necessary institutional structure with which to function well.[25]

Social and organizational capital cannot be handed over to a country from the outside. It must be developed from within, even if knowledge from outside about key ingredients can facilitate the creation of this social/organizational capital. The pace of change and the pattern of reforms must be adapted to each country's ability to create social/organizational capital. This factor may, in fact, be the most important constraint on the speed of transformation. In earlier development literature, in the days when it was thought that the main factor separating developed from less developed countries was physical capital, there was considerable discussion of countries' absorptive capacities.[26]

[24] See Wolfensohn (1998) and World Bank (1998a).

[25] Russia's recent experience offers an excellent, if sobering, example. Almost a decade after the process of transition to a market economy began—after the inefficient system of central planning was replaced by a more decentralized, market-oriented system, after the distortionary pricing patterns were, by and large, eliminated, and after private property was supposed to restore incentives that seemed so lacking under the previous regime—output remains a third below what it was before the transition started. The underlying resources may have deteriorated slightly, but the human capital and knowledge base remains. The explanation: the destruction of organizational and social capital, a process which had in fact begun under the previous regime, continued. Policymakers made inadequate efforts to develop new bases, and to provide the the legal infrastructure necessary for markets, including bankruptcy, competition, and contract laws and their effective enforcement.

[26] Rostow (1960, pp. 143-44).

From the perspective of this paper, the issue is not the pace of absorbing capital, but the pace of societal transformation.

China has demonstrated that a country can absorb enormous amounts of physical capital quickly. In the early stages of development, the needs for roads, schools, energy, telecommunications, and other elements of the infrastructure are huge, and it is hard to believe that more resources could not be productively used. But simply providing these ingredients does not constitute development.

There has been much talk of late about capacity-building. The (relatively) easy part of capacity-building is providing the human capacity, the education, the skills, the knowledge required for development. The hard part of capacity-building is the development of the organizational/social capital, including the institutions that enable a society to function well. There are many dimensions to this:

- The enabling environment for the private sector, which includes markets and the legal infrastructure that is necessary for markets to function well
- The knowledge environment, which enables new knowledge to be absorbed, adapted to the circumstances of the country, and put to use
- The policy environment, which includes the capacity to make key decisions concerning development strategies

Consistency, coherence, and completeness

We have described the various pieces that constitute an effective development strategy, from two points of view: the levels on which it must operate, and the building blocks that it must provide. But the whole is more than the sum of the parts, and the parts must not only be consistent with each other, but must also must fit together, and together set forth a road map—a vision of the future combined with a framework for realizing that vision.

The development strategy envisioned here is not a one-year plan, or even a five-year plan. The fruits of enhancing nutrition or education to a pre-school child will not be fully felt until a decade or more later. The vision must be long-term, while at the same time pointing to actions to be taken today. To be meaningful, the vision and actions must be set within a coherent framework, which requires setting priorities, encouraging partnership, and taking into account the global and regional environment.

Priorities. We know that so much is needed for successful development, including the actions listed above and more. Earlier, we emphasized that, given limitations on our resources—including our and the developing country's administrative capacities—we need to set priorities. We argued earlier that one of the purposes of a Development Strategy was to establish these priorities. We can now flesh out in greater detail both the principles for setting priorities and what are the priorities which most less developing countries will share. In particular, we and developing country governments need to focus on leveraging—on identifying areas where their limited actions can have large-scale effects, and where absence of requisite action on their part can have disastrous effects. Although the particular priorities will differ from country to country, there are some common elements.

- Among the most important is *education*, because without education a country cannot develop, cannot attract and build modern industries, cannot adopt new growing technologies as rapidly in the rural sector. But most fundamentally, if development represents the transformation of society, education is what enables people to learn, to accept and help engender this transformation. Education is at the core of development.
- *Infrastructure*—and in particular communications and transportation—is vital for the conduct of business in the modern world. It is also necessary to reduce the sense of isolation of those in developing countries, which is one of the most crippling aspects of underdevelopment. But today, we realize that much of the infrastructure can be provided privately, provided that the government establishes the appropriate regulatory/legal environment. Doing so much be given a high priority.

- *Health*—because an unhealthy population cannot be a productive labor force, because a basic standard of health should be viewed as a fundamental human right, because it is unconscionable that diseases that could be eradicated or at least controlled continue to afflict millions in the less developed world, often robbing them of any human dignity. Today, however, we recognize that actions exist at least as important as the provision of medical services in maintaining overall health--including warning against dangerous behaviors (like smoking) and encouraging other behaviors (like good diets).
- *Knowledge*—because, like education, it enriches the human spirit, and because, like education and health, it leads to a more productive society. The power of knowledge is enormous: with increased knowledge, the output that can be produced with the limited amounts of resources can be multiplied by orders of magnitude.
- *Capacity-building*—because in the end, successful development, a successful transformation must come from within the country itself, and to accomplish this, it must have institutions and leadership to catalyze, absorb, and manage the process of change, and the changed society.

Partnership and country assistance strategies. A country's own development strategy provides, then, the overall framework for thinking about a country's plan for change. Within that framework, various donors, including the World Bank, can act as partners in the development effort by identifying where they can be most effective. These roles will include not only transferring capital, but also providing knowledge that is essential for development and capacity building.

But partnership goes beyond the country and the aid donors. Recall that development entails transformation of the whole society; hence the whole society must be engaged. The development strategy needs to outline how this engagement will occur. It should set forth, for instance, a view about the role of government, and within the public sector, a framework for decentralization: it needs to describe areas where the private sector and civil society should take the lead, and more broadly the "terms of the partnership" among government, private sector, and civil society.

Consistency with the global and regional environments. We have emphasized that all five components of the development strategy are interrelated; for instance, strategies for the private sector must be complemented by strategies for the public sector; strategies at the national level must be complemented by strategies at the community level. At each level, the strategy must be consistent with the environment within which it is embedded, at levels above and below. And all of the strategies are embedded within an ever-changing global environment. This global environment has opened up new opportunities—vast international markets for goods, so that countries need not be limited in their growth to domestic demand, and the possibility of vast flows of international capital to complement domestic resources. But these opportunities have been accompanied by new challenges. For example, heavy dependence on exports of goods or imports of capital exposes a country to the vicissitudes of markets abroad, such as a foreign economic downturn that may close off opportunities for exports or a sudden change in investor sentiment that may reduce sharply the capital inflows from abroad. The magnitude of these risks may depend little on how well the country manages its own economy. It takes strong government actions, and strong economic institutions, to weather these storms—and even then there may be large costs to the economy. For many less developed countries, the impacts may be—and experience has shown frequently are—disastrous. An essential part of the new development strategies must be to take advantage of the new global environment while at the same time reducing the country's vulnerability to the inevitable shocks that are associated with global engagement.

All countries, developed and less developed, share our planet, and thus must husband together our globe's scarce resources, including the atmosphere. The preservation of our atmosphere—avoiding the build-up of greenhouse gases—is an example of an international public good, the benefits of which accrue to all people.[27] A development strategy needs to set forth a vision of how these international collective needs are to be addressed.

There is another aspect of global development, which becomes particularly important when one sees development through the lens of a societal transformation. We have seen that some countries have had remarkable success in making that transformation, and that there is much those who are in the early stages of a transition can learn from those experiences. As more successes (and failures) occur, these successes (and failures) have impacts on others, as each extracts the lessons that can be learned from each of the experiences. The spreading of experiences no doubt played a role in the successive development of the countries within East Asia.

At the same time, many countries' strategies must be set within the context of developments within their region. This is especially true of small countries, and even more so of land-locked countries, for whom access to markets is critical. But it is not only transportation issues that have to be dealt with on a regional level. There are, for instance, a myriad of environmental and natural resource issues (most notably dealing with water) that can only be addressed at a regional level.

[27] For a discussion of the concept of an international public good, see, for instance, Stiglitz (1995).

V. Learning from Openness: Trade, Foreign Capital, and the New Development Strategy

Where does openness to the outside world fit into this vision of a new development strategy? Our new understanding of development as a transformation of society—rather than just the accumulation of physical or even human capital—gives us a lens with which to examine this question. It reveals that trade can play a crucial role, although not through the mechanisms that economists have traditionally stressed.

Trade and the development transformation

Let me take a moment to explain this. In the standard textbook model of international trade, openness to foreign goods is supposed to bring benefits primarily through its effects on the market price of imported goods. If Indonesia produces midsize automobiles domestically at a cost of $40,000 each but can import them at $20,000 apiece, then opening to auto imports yields a net gain in welfare: the increase in consumer surplus more than offsets the fall in profits enjoyed by Indonesian manufacturers. Indonesia can then move the resources formerly employed in producing cars—the idle labor, human and physical capital, and land—and shift them into an industry in which the country has a comparative advantage (textiles, in the classic story). Barring terms-of-trade effects, the resulting increase in efficiency will allow Indonesia to be better off as a result of trade liberalization, even if we don't assume that foreign countries respond with market-opening of their own. The magic of comparative advantage is that a poor country benefits from trade even if, in absolute terms, its productivity is lower than its trade partners' across the whole range of goods.

This standard model tells an important tale, but one that is far from the whole story. There is much more going on, in ways that contribute directly to the transformation of society. Consider the gaps between the standard Hecksher-Ohlin trade model and what we see in practice. First, both rigorous empirical research and country experience suggest that the growth effects of engagement in the global marketplace are far larger than would be predicted by the standard model.[28] Many specifications of empirical growth regressions find that some indicator of external openness—whether trade ratios or indices of price distortions or average tariff level—is strongly associated with per-capita income growth.[29] And countries (especially small, poor ones) that have tried autarky have typically found themselves lagging far behind in development, for reasons that apparently stem in part from their closed borders. Yet the standard Hecksher-Ohlin model predicts gains from trade that are relatively small, consisting only of the well-known Harberger triangles in the supply-demand diagrams. Clearly, something is missing from the standard story.[30]

A second problem is that industry-level evidence is also inconsistent with the standard model. Recall that in that model, trade causes economies to shift intersectorally, moving along their production frontier. But in reality, the main gains from trade seem to come from an *outward shift* of that production frontier, with little intersectoral movement. In essence, trade makes it possible for the economy not just to consume a given basket of goods at lower cost, but also to *produce* a given pre-opening set of goods at lower cost. (And any increase in quantities can be explained by the producers' Harberger triangles.)

What is going on here? The evidence suggests strongly that opening up to the outside world leads to an improvement in the technology of production. When I say "technology", I have in mind something far broader and more important than the technical blueprints that lie behind the production of any given good. "Technology" here means anything that affects the way in which inputs are transformed into outputs—not just blueprints, but also market and non-market institutions and modes of organizing production. A major difference between developed and less developed countries is the difference in the efficiency with which inputs are transformed into outputs;[31] trade reduces

---

[28] See, for example, Romer (1994).
[29] See, for example, Sachs and Warner (1995).
[30] The most important gains from trade may come from the increased variety of goods—particularly goods that are inputs into production processes—to which an open trading system offers access (Rodriguez-Clare 1996 and Stiglitz 1997b). That is, rather than just reducing the price of goods that are already available domestically, trade also offers access to many goods (such as semiconductors or numerically controlled machine tools) that simply were not available *at any price* under autarky. The new inputs bring down costs and spur innovation in the importing economy.
[31] The 1998/1999 *World Development Report* (World Bank 1998) focuses on these issues, emphasizing that it is knowledge (broadly defined) and not just inputs of physical or even human capital that matters. In standard economic models,

the discrepancy.

If what we are concerned about is the transformation of society, then we must adopt policies that ensure that openness leads to that broad transformation. It is crucial that trade and foreign direct investment not be confined to small enclaves, even if those enclaves give a temporary boost to our statistical measures of national output. For example, a wealth of gold resources in an area far from a country's population base might well be successful at attracting FDI and increasing mineral exports, but may well do little to spur development over the long term. In designing policies to spur openness and capture its potential benefits, we need to focus on realizing the transformative power of interaction with the outside world. To put it succinctly, our goal should be *not a dual economy, but a developed economy*.

Both trade and foreign direct investment have important roles here. Our understanding of how these roles work remains incomplete, but it is growing. I've already spoken a bit about trade. FDI is of similar importance, because when capital enters a country through direct investment, it typically comes in a package with management expertise, technical human capital, product and process technologies, and overseas marketing channels—all of which are in scarce supply in the typical developing country. Evidence suggests that if the society puts in place the appropriate complementary policies and structures, FDI can give a boost to the technological level and growth of the host country. The fears about FDI in the 1960s and 1970s were based largely on the notion of FDI as an enclave phenomenon; in its more modern incarnation, which is typically better integrated into the surrounding society, FDI is something to attract, not to fear. International competition among multinationals has become more robust, so that the foreign corporation receives fewer monopoly rents and the host country gets a larger share of the benefits from investment.

$$Q = A\, f(\underline{x}, \underline{y}),$$

where Q is output, A is a measure of efficiency, $\underline{x}$ is a vector of factor inputs, and $\underline{y}$ is a vector of traded inputs. The standard theory argues that $\underline{y}$, the vector of traded inputs, is a function of market prices $\underline{v}$; distortions in $\underline{v}$ caused by autarky lead to lower Q for any given $\underline{x}$. By contrast, in the newer perspective discussed above, trade may play its most important role in increasing A.

Implications for the international architecture and financial flows

In recent months, the rethinking and soul-searching that has followed the global financial crisis has led to much discussion of how to redesign the international financial architecture. The new development strategy that I've outlined here has important implications for that design process. How, for example, should we think about short-term capital? First, note that short-term capital is especially volatile, as the experience of the past year has reminded us repeatedly. Even as FDI flows have largely continued unabated, short-term capital flows have completely reversed in many of the crisis countries. Second, short-term capital has none of the added benefits brought by FDI—benefits that seem ancillary in the old view of development as accumulation of capital, but that are recognized as *central* when we view them through the lens of the new development strategy. With today's volatility of short-term capital, one cannot make good long-term investments based on this short-term capital. But equally important, short-term capital does not in itself bring development transformation. (Similarly, hedge funds don't bring development, especially if they go bankrupt.) Indeed, in societies with high domestic saving rates and hence relatively low quality of marginal investments, short-term capital may retard that transformation. The high development costs exacted by abrupt capital-flow reversals—the lost years of education, the rise in infant mortality, the job losses—can easily swamp any marginal benefit derived from such flows, as happened in East Asia.

Implications for the developed countries: What are their responsibilities?

It is clearly in the interest of developing countries to engage fully with the world through trade and through attracting foreign direct investment. But the trade policy agenda for the developing world—or at least the agenda advocated for developing countries by the West—has in recent years suffered from its single-minded focus on liberalization through reduction of trade barriers *in those countries*. To complement this argument, important as it is, we need to ask also, what are responsibilities does the *developed* world have in the area of trade policy? It is not for me to lay out all those responsibilities here, but let me suggest several developments that have clearly helped delay the progress toward transformative development through openness:

- First, the Uruguay Round trade agreement—for all the benefits it brought to the world's consumers, producers, and taxpayers—did too little to ensure the opening of markets to developing-country exports. Consider the empirical estimates of net benefits by region, calculated just after the agreement was signed: according to these estimates, sub-Saharan Africa was a net *loser* as a result of the Uruguay Round.[32] To be sure, Africa failed to gain largely because it did too little to liberalize its own barriers to trade, thus depriving itself of the opportunity to lower costs and spur efficiency and innovation domestically. But the Round also offered relatively little in the way of new market access for the products that Africa is most able to export. As suggested by the experiences of East Asia's economies, much of the learning opportunity offered by trade takes place in export markets, as developing-country firms build relations with sophisticated customers and compete head-to-head with the best producers in the world. Success in export markets requires learning, and the export champions can then bring these lessons home to apply in the domestic market. Note that I am not claiming here that lack of market access is the only, or even most important, barrier to African exports. African countries can still do much to make life easier for exporters, whether by improving communications infrastructure, revamping transportation facilities, or reducing unnecessary bureaucratic obstacles to exports. But market access is one area where the developed world is uniquely positioned to give a boost to the development transformation that I have called for.
- Second, and a related point, is that we must continue working to stem the tide of the new protectionism in the West. The last two decades have seen a rise in the use of creative new measures to block imports. Examples include nuisance anti-dumping claims, lodged under laws that often make little economic sense;

[32] Harrison, Rutherford, and Tarr (1995).

countervailing duties that similarly lack objective justification;[33] and barriers to genetically altered products, which are likely to become steadily more important as developing-country exports make greater use of those products. Developed countries often have the luxury of large and well-paid legal and lobbying industries in their capitals, industries that can be quite innovative in devising new means of restricting competition. From an equity standpoint, it is essential that we stamp out these innovations as energetically as we work to lower developing-country barriers to trade.

- Third, international protection of intellectual property rights (IPRs) should strike a balance between the interests of producers and users. Those users include not only many firms and consumers within the developing world—who are more often technological adapters and users than innovators—but also the academic community throughout the world (developed and developing). Yes, it is important to give incentives to innovators by ensuring them a return on their investment in R&D. But we must remember that knowledge is a crucial input into production processes, whether in agriculture or high-tech industry, and that unlike physical inputs into production, knowledge can be shared *ad infinitum* without any additional cost. Thomas Jefferson likened the creation of knowledge to the lighting of a candle in the darkness: many other candles can draw their light from that first candle without diminishing its power or brilliance. Excessive protection of IPRs may end this virtuous cycle of knowledge transmission and regeneration in the developing world. There is no easy answer, but that should not stop us from asking questions. It is for this reason that we have devoted a section in this year's *World Development Report* to the issue of intellectual property rights.[34]

In all these cases, we should seek to construct not just good policies, but also a sense that the process by which policies are devised is itself *fair and open*. Without such a sense of

[33] For a discussion of these barriers, see Finger (1993) and Stiglitz (1997a).
[34] World Bank (1998a).

fairness, the developing world will retreat from its reforms of recent decades. Worse still, the perception of hypocrisy reinforces the sense of unfairness: even as the more developed countries preach the doctrines of openness, they engage in restrictive practices. Even as they preach that countries must undertake the painful measures of liberalization—which may entail losses of jobs and industries—developed countries use anti-dumping and safeguard measures to protect their own industries that are adversely affected. Moreover, they do so even when their economies are at full employment, so that the risks of extended unemployment are minimal, in marked contrast to the situation in many less developed countries, where unemployment is high and safety nets are inadequate. And even as the developed countries dismiss the political problems facing less developed countries, they justify their own resort to these protectionist measures as necessary to overcome even worse protectionist sentiments within their own countries.

As I said in my Fiesole speech earlier this week, the pendulum of opinion has swung before, and it now risks swinging too far back in opposition to openness.[35] Our task is to lessen the momentum of this pendulum swing, by increasing the equity of the international architecture for trade and finance. Retreat from openness in the developing world would unacceptably delay the development transformation that it so sorely needs.

[35] Stiglitz (1998d).

VI. Concluding Comments

We have learned in the last half-century that development is possible, but also that development is not inevitable. We have learned that development is not just a matter of technical adjustments, but a transformation of society.

In my opening remarks, I referred to the disillusionment with the Washington consensus, which provided a set of prescriptions that failed to foster this development transformation. That consensus was too narrow both in its objectives and its instruments. I have tried in this lecture to set out the foundations of an alternative paradigm to the Washington consensus. In a way, what I have said is far from revolutionary: within the World Bank and the development community more broadly, there has been increasing attention over recent decades to issues of health and education, and we have moved beyond measures of GDP to look at lifespans and literacy rates. We have recognized the importance of economic security, and stressed the creation of safety nets. There has been a growing consensus behind the objectives of democratic, equitable, and sustainable development. Here, I have tried to argue that the whole is greater than the sum of the parts, and that successful development must focus on the whole—the transformation of society. We are well prepared for this task, precisely because we have increasingly taken within our ambit a broader range of issues—even though all too often we have underemphasized important components, such as the role of competition and financial markets and the institutional infrastructure more broadly.

But I have also tried to argue here that a successful development transformation affects not only what we do, but how we do it. Yes, this broader perspective affects the strategies and policies, but it also affects the processes. It argues for openness, partnership, and participation, words that too often sound like appeals to the politically correct nostrums of the day. I have tried to argue that there lies behind these words a theory of development, as well as evidence that these processes can lead to more successful development efforts.

Honesty, however, requires me to add one more word. In calling for a transformation of societies, I have elided a central issue: transformation to what kind of society, and for what ends? Further, some have worried that development will destroy traditional values. In some cases, there will be a clash between science and traditional beliefs. But development today often focuses on the preservation of cultural values, partly because these values serve as a cohesive force at a time when many other such forces are weakening. Maintaining social organization and enhancing social capital are part of the key to successful development transformations. Moreover, it is important to note that much of the progress that is associated with successful development—the mothers who do not have to see their children die in infancy, who see the opening of minds to new knowledge and the increased opportunities—these reflect almost universally held values.

But there is a further reason that I believe in openness, especially openness in process: these contribute to a more open, democratic society. For me, these are values in their own right.

References

Bruno, M. and W. Easterly. 1998. "Inflation Crises and Long-Run Growth." *Journal of Monetary Economics* 41(1), February, 3-26.

Deininger, K., and L. Squire. 1996. "A New Data Set Measuring Income Inequality." *World Bank Economic Review* 10(3), 565-591.

Demirgüç-Kunt, A. and E. Detragiache. 1998. "Financial Liberalization and Financial Fragility." Paper presented to the Annual World Bank Conference on Development Economics, Washington, D.C., April 20-21.

Finger, J. M., ed. 1993. *Anti-Dumping: How It Works and Who Gets Hurt.* Ann Arbor: University of Michigan Press.

Furman, J. and J.E. Stiglitz. 1998. "Economic Crises: Evidence and Insights from East Asia." Brookings Papers on Economic Activity. Forthcoming.

Harrison, G. W., T. F. Rutherford, and D. G. Tarr. 1995. "Quantifying the Uruguay Round." In Martin, W., and L. A. Winters, eds., *The Uruguay Round and the Developing Economies"* (World Bank Discussion Paper 307).

Isham, J., D. Narayan, and L. Pritchett. 1995. "Does Participation Improve Performance? Establishing Causality with Subjective Data." *World Bank Economic Review* 9(2).

Jimenez, E. and Y. Sawada. 1998. "Do Community Managed Schools Work? An Evaluation of El Salvador's EDUCO Program," Impact Evaluation of Education Reforms Working Paper Series, Development Economics Research Group, World Bank, February.

King, E. and B. Ozler. 1998. "What's Decentralization got to do with Learning? The Case of Nicaragua's Education Reform," Impact Evaluation of Education Reforms Working Paper Series, Development Economics Research Group, World Bank, April.

Rodriguez-Clare, A. 1996. "Multinationals, Linkages, and Economic Development." *American Economic Review,* 86:4 (September), 852-73.

Rodrik, D. 1998. "Who Needs Capital-Account Convertibility?" *Essays in International Finance* 207, International Finance Section, Department of Economics, Princeton University,(May): 55-65.

Romer, P. 1994. "New Goods, Old Theory, and the Welfare Costs of Trade Restrictions." *Journal of Development Economics,* pp. 5-38.

Rostow, W.W. 1960. *The Stages of Economic Growth: a non-Communist Manifesto*. New York: Cambridge University Press.

Sachs, J. D. and A. M. Warner. 1995. "Economic Reform and the Process of Global Integration." *Brookings Papers on Economic Activity*, 1-95.

Stiglitz, J. E. 1994. *Whither Socialism?* The Wicksell Lectures, 1990. Cambridge, Mass: MIT Press.

__________. 1995. "The Theory of International Public Goods and the Architecture of International Organizations," United Nations Background Paper 7, Department for Economic and Social Information and Policy Analysis, July.

__________. 1996. "Some Lessons from the East Asian Miracle." *The World Bank Research Observer* 11(2): 151-77.

__________. 1997a. "Dumping on Free Trade: The U. S. Import Trade Laws." *Southern Economic Journal* 64:2 (October), 402-424.

__________. 1997b. "Trade and Technology: Links and Problems." Paper presented to the Annual World Bank Conference on Development in Latin America and the Caribbean. Montevideo, Uruguay: June 29-July 1.

__________. 1998a. "More Instruments and Broader Goals: Moving Toward the Post-Washington Consensus." Presented as the WIDER Annual Lecture, at the World Institute for Development Economics Research in Helsinki (January).

__________. 1998b. "Responding to Economic Crises: Policy Alternatives for Equitable Recovery and Development." Presented at the North-South Institute Seminar. Ottawa, Canada: September 29.

__________. 1998c. "Must Financial Crises Be This Frequent and This Painful?" Presented as the McKay Lecture, University of Pittsburgh, Pennsylvania: September 23.

__________. 1998d. "Towards a New International Economic Architecture: Principles and Policies." Presented at the European Investment Bank, Fiesole, Italy: October 15.

Williamson, J. 1990. *Latin American Adjustment: How Much Has Happened?* Washington, D.C.: Insitute for International Economics.

__________. 1997. "The Washington Consensus Revisited." In L. Emmerij, ed. *Economic and Social Development into the XXI Century* (Washington, D.C.: Inter-American Development Bank), 48-61.

Wolfensohn, J.D. 1998. "The Other Crisis." World Bank/IMF Annual Meetings Address (October 6).

World Bank. 1993. *The East Asian Miracle: Economic Growth and Public Policy*. A World Bank Policy Research Report. New York: Oxford University Press.

__________. 1995. *Structural and Sectoral Adjustment: World Bank Experience, 1980-92.* A World Bank Operations Evaluation Study.

__________. 1996. *Poverty Reduction and the World Bank: Progress and Challenges in the 1990s*. Washington, D.C.: World Bank.

__________. 1997a. *China 2020: Development Challenges in the New Century*. Washington, DC: World Bank.

__________. 1997b. *World Development Report 1997: The State in a Changing World.* New York: Oxford University Press.

__________. 1998a. *World Development Report 1998/99: Knowledge for Development.* New York: Oxford University Press.

___________. 1998. *Assessing Aid: What Works, What Doesn't, and Why.* World Bank Policy Research Report, Washington, D.C.: Oxford University Press.